METHODS OF AUDITING AND ACCOUNTING IN A BOND HOUSE

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Before undertaking to outline a method of auditing and accounting in a bond house, it would seem desirable to consider the nature of a bond business and what a bond house is called upon to do. A bond house is a partnership or corporation (usually a partnership) the principal business of which is to buy and sell bonds. In the conduct of its business it may buy and sell as principal, or it may buy and sell as agent, *i. e.,* the proprietors may be bond merchants, or they may be bond brokers or both. As bond merchants they may buy and sell direct, or they may buy and sell through brokers. To the end of facilitating its business a bond house or some of the partners may hold memberships in stock exchanges. For outside trading the house may have a large staff of salesmen, some of whom are local, visiting investing offices and prospective purchasers in the financial centers where the bond house is situated, others of whom are traveling salesmen, going from city to city to dispose of issues on hand. Each salesman may have his own constituency, working for the house on commission, or on salary, or both. Bond houses which purchase state and municipal issues direct, also have representatives who visit the state capitals, county seats, and city offices where bonds are to be disposed of, for the purpose of examining the laws, ordinances and proceedings authorizing the issues as a means of determining their validity before bids are submitted.

In the usual course of business bond houses frequently act as managers of syndicates; as fiscal agents for the purpose of paying interest on various issues of bonds, and as underwriters of bond issues. They may participate in these underwritings, or in others; they may participate in syndicates, joint accounts and pool accounts; they borrow money and deposit bonds owned as well as bonds held for

customers as collateral; they borrow bonds for deliveries on short sales; they may also, for the accommodation of customers, do a private banking business. These several relations and functions are mentioned to indicate the character of the accounts to be kept and audited.

The Purposes and Advantages of an Audit

The purposes of an audit may be briefly stated as follows:

1. To prove the clerical accuracy of the bookkeeping.
2. To verify the authority for entries.
3. To prepare a true statement of financial condition.
4. To prepare a true statement of earnings and expenses, and of profits and losses.
5. To determine whether any of the employees and agents have been guilty of infidelity to the proprietors or their co-employees and co-agents.

To a concern whose business is so largely conducted by employees and agents, whose clerks and messengers are entrusted with so much of value that can be easily converted into cash, and which itself carries on a business as trustee and serves in so many fiduciary relations it would seem unnecessary to suggest the desirability of an audit. The accounts being kept by clerks and frequently under high pressure, proof of the clerical accuracy of the bookkeeping is essential to a correct statement of financial condition, or financial results. A business which combines its own assets with the assets of customers, and which accepts various trust relations, should know, for its own protection, that its own financial condition is properly represented in its accounts. A house which trades for itself as well as for customers should have stated by some disinterested person that its profits and losses are truthfully reported. As the many purchases, sales, deliveries and payments are conducted by employees, those who have acted in good faith should have some independent means of having it represented to their employers that each has properly accounted for money and securities that have come into his possession. Moreover, it might be made a valuable trading asset to a bond house to have it known to customers that their accounts are regularly audited by a reputable firm of accountants.

Method of Making the Audit

Owing to the peculiar nature of the business, it is of advantage to begin the audit after the close of the exchanges. Three o'clock in the afternoon is usually chosen as the time most opportune for taking possession of the office. It is generally considered desirable not to advise the office staff when an audit of the books and accounts of a bond house, or in fact any business, is to be made. The officers and employees should not be given an opportunity to adjust either the books or the cash and securities in hand for the expected visit of an examiner.

Proof of clerical accuracy of the bookkeeping and verification of authorities for entries do not differ materially from similar proof and verification in audits of other concerns and therefore need not be described in detail.

Those features of the audit which look toward verification of present financial condition, or assets and liabilities, begin with the balance sheet, or, in case no balance sheet has been prepared, with the verification of the asset and liability accounts of the trial balance. At the time of taking possession, the cash on hand should immediately be counted and trial balances of the several ledgers drawn off, together with lists of the securities owned or held for customers and of the securities deposited with other concerns. This plan is suggested for the reason that in the bond business changes are constantly occurring, that is, the securities owned or held for customers to-day may not be the same to-morrow, and substitutions of collateral with banks to secure loans are constantly being made. It is always desirable to get as much information as may be possible concerning the accounts before any changes occur. As a part of the audit of cash, a verification should be made of the bank balances. This verification is obtained by certificates from the several banks as to the amount on deposit. All confirmations and certificates should be mailed directly to the auditor making the examination. This is best accomplished by written request, approved by an officer of the company under examination, enclosing stamped envelope addressed to the auditor. The balances shown by the bank pass books should never be relied on—they are not final, being memoranda only, and are too easily modified to conform to the accounts.

All securities on hand, whether belonging to the company or

held in trust, should at once be taken into possession by the auditor, which possession should not be released till both the cash and the securities have been counted, and the securities have been checked against the list previously referred to. The amount of securities counted, whether owned or held for customers, should agree with the ledger accounts of securities on hand, unless it appear that some of them are in the possession of other parties, in which case confirmations must be obtained in the same manner as the verification of bank balances. In Wall Street this is commonly called "balancing stock." In counting coupon bonds, it should be noted whether or not all undue coupons are attached. If any undue coupons have been detached or are missing, this fact should be noted and the reason for such a condition be determined, as by detaching coupons not due, the value of the bond has been depreciated and the account should be reduced correspondingly. As to the ownership of bearer bonds, tests may be made by comparing the bond numbers with the numbers shown in the books, or delivery slips. If the numbers do not agree, it is an indication that the bonds may have been tampered with, and it may develop that missing bonds have been temporarily replaced by other bonds for an expected audit.

Aside from liabilities to customers for securities held for their account, the liabilities of a bond house are verified in the same manner as in other audits. For the purpose of this verification, statements should be mailed to all customers on the same afternoon that the examination is started, showing their ledger balances and the securities held for their account, with the request for confirmation. Statements should also be sent to the different banks, with which the house may do business, as to the amount of loans, and also as to the securities in their possession to secure loans, asking for confirmation.

The verification of earnings and expenses and of profits and losses is made as in other audits, except that the profits or losses on trading for customers should be carefully allocated from the profits and losses on trading for the house, the profits and losses of customers operating to increase or decrease the liabilities of the house to customers.

Underwriting

One of the most important parts of the business conducted by many bond houses is the underwriting of bond sales. The underwriting of a bond issue is a contractual undertaking by the bond house insuring the sale of the issue at a stipulated price, the essence of the contract being that in case the issue is not disposed of by the banker or selling agent at the price agreed on or better, the bond house will take such part as remains unsold. This conditional or contingent liability may not be set up on the books. When a bond house underwrites it usually becomes the selling agent or broker as well.

The bonds are offered for sale by circular letters mailed to customers, through traveling salesmen and by advertisement. In this respect the bond business is similar to that of an iron broker or coffee broker. Bonds are taken in large quantities (wholesale) and sold in wholesale lots to large houses or in small quantities (retail) to investors and small dealers. When the term of the underwriting expires the bond house takes over the unsold portion of the issue as bonds purchased.

In auditing these accounts, it is necessary to call for the underwriting agreement, which generally shows the amount underwritten, the price guaranteed, rate and nature of commission, etc. The first entry appearing on the books in connection with a transaction of this nature should charge "bonds owned," and credit the party or parties from whom the bonds were purchased at the stipulated price. As the bonds are sold, "bonds owned" should be credited with the proceeds. In checking the cash receipts or the charges made for the bonds sold, frequent reference to the order should be made to see that the price charged is correct and that the full amount represented by the bonds sold and delivered has been credited to the account. The bonds which have not been disposed of and which are represented by the balance remaining in the account should be included in the count of securities on hand, or, if on deposit with other parties, confirmed in the usual manner.

Syndicate Managers

Bond houses very often act as syndicate managers. They may or may not participate in the syndicate, as the case may be. In

transactions of this nature an account with the syndicate should be opened on the books and this account should be charged and credited with all of the transactions relating to the syndicate. To audit these accounts it is first necessary to examine the syndicate agreement. Agreements of this class generally show in detail the nature of the business to be transacted, the rate of commission the syndicate managers shall receive, and all of the data necessary to a complete understanding of the situation. If the syndicate owns securities or has any securities temporarily or otherwise under its control, they should be verified by actual count or by confirmations. No charges or credits should be made to the syndicate account other than those authorized under and in accordance with the terms of the syndicate agreement. A bond house will frequently participate in a syndicate agreement or underwriting with an outside party as the syndicate manager. In this event, a certificate should be obtained from the syndicate manager as to the amount the bond house has contributed to the syndicate. The amount so determined should be reconciled with the ledger account. The syndicate agreement will sometimes show what these contributions should have amounted to.

Fiscal Agents

Many bond houses act as fiscal agents, for the purpose of paying interest on certain bonds. The bond house should keep a separate account on its books with each of the several concerns it may represent. These accounts may frequently, with advantage, be subdivided by coupon number or maturity dates. The accounts should be credited with the money received from the principal and charged with the coupons paid. The paid coupons should be forwarded periodically to the principal, together with a statement of account. A receipt should be taken for the canceled coupons so returned. In auditing these accounts, all paid coupons which have not been returned to the principal should be counted. The ledger balance should be confirmed by means of a certificate from the principal and the amount of paid coupons on hand.

Proof as to the Fidelity of Employees

In general, the proof of the fidelity of employees of a bond house comprehends the same features as similar proof for any

financial institution. The verification of cash and securities has already been described. In auditing the books and accounts it is a wise precaution that may with profit be taken (unless the privilege is denied by the officers, in which case an exception may be noted) for the auditor to open and handle two or three days' mail. This will aid the accountant in many ways, such, for example, as in the verification of items in transit. Many irregularities have been concealed by using to-day's receipts to cover yesterday's shortage. Such a condition would necessarily be developed by this plan, and the opening and handling of the mail may also develop other clues for the accountant.

In connection with his audit the accountant should determine whether or not all of the interest on the bonds owned and on those held for customers has been collected at each interest date during the entire period covered by the audit. All deliveries of bonds should be verified by the receipts signed by the party who received the bonds, and the date of the receipts should be checked against the date of delivery shown by the books.

Accounting Methods

Nearly all bond houses are constantly receiving bonds from customers for sale at certain prices, or for exchange for new securities, or for other reasons. All such deposits should be recorded immediately on the general books under captions which would properly represent the trust relations under which they are received. They might be entered upon the books at some arbitrary figure, par is suggested, but whatever figure is used, it should always be uniform. Unfortunately, some bond houses fail to make any record of these accounts on their general books and many do not even keep duplicates of such receipts as may be given for securities so received. Such a practice is a constant inducement held out to employees to make use of such securities for their own purposes, as no accurate verification of the securities which should be on hand is possible under such a system. In the cases referred to, no confirmations from customers can be obtained by the accountant, as there is no record on the general books as to who the customers are. The same observation would apply to money received as deposits accompanying bids for securities. In many instances these checks are held without being recorded on the books until it is subsequently

decided whether bids will be accepted or the money returned. Where a bond house fails to make an immediate record on its general books of all securities received by it for any purpose whatsoever, and of all money received, there is always a possibility that a shortage may exist in the accounts which would not be detected by a most thorough or exhaustive audit. If irregularities were detected it would be by fortuitous circumstances rather than by application of methods based on professional care and foresight.

The accounting system in a bond house should be so arranged that the general books will have a controlling account over each of the several cages and departments. The general books should show what cage No. 1 is responsible for, what the coupon department is responsible for, what the foreign department is responsible for, and so on. Each of the departments could, under this method, be audited independently. Errors would be localized, and the blame, when there was blame, placed on the proper party. When entries are made of securities deposited for safe keeping, or of moneys deposited on bids, the books or memoranda showing these transactions should also be made a part of the system under control and proper accounts opened on the ledger, as a means of informing the officers of the company and the auditor, as to the amount of the liability of the house on these accounts.